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SENSITIVE

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SUBJECT: CROATIA'S LIMITED ECONOMIC CHOICES

(U) SENSITIVE BUT UNCLASSIFIED; PLEASE HANDLE ACCORDINGLY.

¶11. (SBU) SUMMARY: ALTHOUGH CROATIA ENJOYS MODEST ECONOMIC GROWTH AND LOW INFLATION, TWO SUCCESSIVE GOVERNMENTS HAVE DONE LITTLE TO SIGNIFICANTLY BOOST ECONOMIC ACTIVITY OVER THE PAST FIVE YEARS. PARTIALLY, THIS IS THE RESULT OF POLITICAL INERTIA AND AN UNWILLINGNESS TO CONFRONT ENTRENCHED INTERESTS, BUT IT IS EQUALLY A CONSEQUENCE OF ECONOMIC IMBALANCES FOR WHICH THERE ARE NO READY SOLUTIONS. THE CONFLUENCE OF STUBBORNLY HIGH FISCAL DEFICITS, A GROWING TRADE DEFICIT, SOARING FOREIGN DEBT, DOUBLE-DIGIT UNEMPLOYMENT AND AN OVER-VALUED DOMESTIC CURRENCY SEVERELY CIRCUMSCRIBES THE GOVERNMENT'S ABILITY TO USE EITHER FISCAL OR MONETARY POLICY TO BOOST CROATIA'S ECONOMIC GROWTH. END SUMMARY.

ECONOMIC GROWTH AND PERSISTENT IMBALANCES

¶12. (SBU) CROATIA'S ECONOMY HAS GROWN AT A MODEST RATE FOR EACH OF THE PAST SIX YEARS, WITH PRELIMINARY FIGURES INDICATING A GDP GROWTH OF APPROXIMATELY 4.0 PERCENT IN 2005. ALTHOUGH 4.0 PERCENT GROWTH IS CONSIDERED STRONG IN MORE DEVELOPED ECONOMIES, IT IS RELATIVELY LACKLUSTER FOR A TRANSITION ECONOMY LIKE CROATIA'S AND DOES LITTLE TO REPLACE THE LARGE NUMBERS OF JOBS LOST OVER THE LAST 15 YEARS AS OLD INDUSTRIES FAILED OR WERE RESTRUCTURED. CONSEQUENTIALLY, CROATIA'S UNEMPLOYMENT RATE HAS REMAINED HIGH DESPITE ECONOMIC GROWTH, RUNNING AT 18.5 PERCENT IN 2004, ACCORDING TO OFFICIAL STATISTICS. (NOTE: THE ILO, WHICH USES A DIFFERENT METHODOLOGY TO CALCULATE UNEMPLOYMENT, GIVES A RATE OF 13.8 PERCENT FOR THE SAME YEAR.)

¶13. (SBU) THE CROATIAN GOVERNMENT'S ENTITLEMENT BURDEN IS SUBSTANTIAL, MADE WORSE BY A GENERAL LACK OF MEANS TESTING FOR BENEFITS AND ENTRENCHED INTEREST GROUPS THAT MAKE SERIOUS REFORM POLITICALLY DIFFICULT. BEYOND THE BURDEN OF UNEMPLOYMENT BENEFITS, THE GOC SPENDS LARGE SUMS ON PENSIONS, HEALTHCARE AND OTHER SOCIAL SPENDING. ON PENSIONS, THE NUMBERS ALONE TELL THE STORY WITH 1 PENSIONER FOR EVERY 1.4 PEOPLE EMPLOYED. AS IN MUCH OF EUROPE, DEMOGRAPHICS ARE NOT IN CROATIA'S FAVOR. CROATIA CURRENTLY SPENDS OVER 7 PERCENT OF GDP ON HEALTHCARE, ABOVE THE EU AVERAGE AND PARTICULARLY UNSUSTAINABLE FOR A TRANSITION ECONOMY. HOWEVER, RECENT EFFORTS TO REFORM THE HEALTHCARE SYSTEM AND INTRODUCE CO-PAYMENTS FOR CONSUMERS WERE SCALED BACK SO THAT AN ESTIMATED SAVINGS OF \$300 MILLION

ANNUALLY WAS REDUCED TO \$50 MILLION, LARGELY THROUGH THE SUBSTITUTION OF BRAND-NAME DRUGS WITH GENERICS. STATE SPENDING EXTENDS WELL BEYOND WELFARE TO INDUSTRY, AGRICULTURE, THE NATIONAL RAILROAD, SHIP BUILDING AND OTHER INDUSTRIES WITH TOTAL SPENDING TOTALING APPROXIMATELY 3 PERCENT OF GDP. ALL TOLD, THE STATE'S ROLE IN CROATIA'S ECONOMY IS ESTIMATED TO BE OVER 40 PERCENT OF GDP.

CHRONIC BUDGET DEFICITS

14. (SBU) WITH SUCH HIGH LEVELS OF PUBLIC SPENDING, IT COMES AS LITTLE SURPRISE THAT THE CROATIAN GOVERNMENT HAS RUN CHRONIC DEFICITS. THE IMF HAS A STAND-BY ARRANGEMENT IN PLACE WITH CROATIA AND HAS SEEN SOME SUCCESS IN REDUCING DEFICITS OVER THE LAST FEW YEARS, WITH A 2005 TARGET OF 4.2 PERCENT OF GDP. HOWEVER, INTERNATIONAL PRESSURE TO REDUCE SPENDING HAS YIELDED MOSTLY DISAPPOINTING RESULTS. THE CURRENT COALITION GOVERNMENT INCLUDES A COLLECTION OF SMALLER PARTIES, SUCH AS THE PENSIONERS' PARTY, WHICH, WHILE LARGELY SUPPORTIVE OF THE GOVERNMENT PROGRAM, IS ABLE TO TAKE THEIR POUND OF FLESH FROM REFORM. AS A RESULT, THE STATUS QUO PERSISTS, DRIVING FURTHER GOVERNMENT BORROWING AND LIMITING THE RESOURCES AVAILABLE FOR KEY INVESTMENT ELSEWHERE. THE GOVERNMENT HAS FINANCED ITS DEFICITS PRIMARILY THROUGH BORROWING AND, TO A LESSER EXTENT, WITH PRIVATIZATION RECEIPTS. OVERALL GOVERNMENT DEBT NOW TOTALS APPROXIMATELY 55 PERCENT OF GDP; CROATIA'S TOTAL FOREIGN DEBT (PUBLIC AND PRIVATE) IS 85 PERCENT OF GDP.

STRONG KUNA HURTS EXPORTS; IMPORTS SURGE

15. (SBU) CROATIA'S IMPORTS HAVE GROWN AT A

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CONSISTENTLY FASTER RATE THAN EXPORTS. THAT A SMALL, OPEN ECONOMY SUCH AS CROATIA'S SHOULD RUN TRADE DEFICITS IS NOT, IN AND OF ITSELF, SURPRISING. HOWEVER, PERSISTENT CURRENT ACCOUNT DEFICITS (ESTIMATED AT 5.9% FOR 2005), COMBINED WITH CHRONIC FISCAL DEFICITS AND MOUNTING FOREIGN DEBT MAKE SOME OBSERVERS UNEASY. THE CROATIAN CENTRAL BANK, ALARMED BY RAPID CREDIT GROWTH AND GROWING FOREIGN DEBT (MUCH OF WHICH ALSO DRIVES IMPORT GROWTH), HAS ACTED SEVERAL TIMES IN THE LAST YEAR TO INCREASE RESERVE REQUIREMENTS FOR NEW LENDING. HOWEVER, THE BANK'S TOOLBOX IS LIMITED AND THE MOSTLY FOREIGN-OWNED BANKS HAVE FOUND WAYS AROUND THESE MEASURES, SUCH AS LENDING DIRECTLY FROM THEIR HOME OFFICES AND USING LEASING ARRANGEMENTS.

16. (SBU) ONE OF THE REASONS CROATIA'S EXPORT SECTOR PERFORMS SO BADLY IS THAT THE NATIONAL CURRENCY, THE KUNA, IS RELATIVELY EXPENSIVE COMPARED TO OTHER CURRENCIES IN THE REGION. THE CENTRAL BANK MAINTAINS A MANAGED FLOAT OF THE KUNA AGAINST THE EURO. THE CURRENT EXCHANGE RATE, HOWEVER, IS PARTIALLY A LEGACY OF STABILIZATION POLICIES IN THE 1990S WHEN THE GOVERNMENT WAS FORCED TO RAISE INTEREST RATES TO CONTROL INFLATION. OVER TIME, HOWEVER, EVEN AS INFLATIONARY PRESSURES ABATED, CROATIA'S ECONOMY HAS BECOME MORE AND MORE "EUROIZED." WITH MOST CONSUMER DEBT AND MUCH PUBLIC DEBT INDEXED TO THE EURO EXCHANGE RATE, THE BANK HAS EFFECTIVELY LOST THE ABILITY TO LET THE KUNA DEPRECIATE SUBSTANTIALLY AGAINST THE EURO.

MULTIPLE PROBLEMS; LIMITED SOLUTIONS

17. (SBU) CROATIA'S POLICYMAKERS APPEAR TO HAVE FEW IDEAS ABOUT HOW TO MAKE THE ECONOMY MORE DYNAMIC. THIS IS ATTRIBUTABLE BOTH TO POLITICAL RISK AVERSION AND TO THE LACK OF SERIOUS DISCUSSION ABOUT THE

OVERALL DIRECTION OF ECONOMIC POLICY IN THE COUNTRY. AS A SMALL COUNTRY HIGHLY INTEGRATED WITH THE LARGER EUROPEAN ECONOMY, THE CROATIAN GOVERNMENT ALREADY HAS FEWER OF THE TRADITIONAL LEVERS OF ECONOMIC POLICY AVAILABLE TO IT. CROATIA'S CURRENT SITUATION LIMITS THOSE CHOICES EVEN FURTHER. ALTHOUGH THE GOVERNMENT NEEDS TO CUT SPENDING AND IS UNDER CONSIDERABLE PRESSURE TO BRING ITS DEFICITS DOWN, SPENDING MEANS JOBS AND, MOST IMPORTANTLY, VOTES. AS A RESULT, SUBSIDIES KEEP FLOWING AND ESSENTIAL PRIVATIZATIONS AND RESTRUCTURINGS ARE DELAYED. THE OPPORTUNITY COST OF THESE CHOICES IS EVEN HIGHER, AS FUNDS ARE NOT AVAILABLE TO DEVELOP MORE PRODUCTIVE AREAS OF THE ECONOMY THAT COULD CREATE NEEDED EMPLOYMENT. LIKEWISE, CROATIA IS UNABLE TO USE MONETARY POLICY TO INCREASE COMPETITIVENESS. WHEN THE EXCHANGE RATE AND SOCIAL CHARGES ARE COMBINED, CROATIAN LABOR IS UNCOMPETITIVE IN MANY INDUSTRIES, WHICH ALSO AFFECTS THE INVESTMENT CHOICES OF FOREIGN COMPANIES CONSIDERING REGIONAL STRATEGIES IN SOUTHEAST EUROPE.

¶8. (SBU) THE GOVERNMENT'S POLICIES APPEAR TO BE BASED ON THE HOPE THAT CROATIA'S ECONOMY WILL SIMPLY OUTGROW SOME OF THESE PROBLEMS. CURRENT EFFORTS ARE LARGEY AIMED AT REDUCING BUREAUCRACY IN AN ATTEMPT TO CREATE A MORE INVESTOR-FRIENDLY ENVIRONMENT. WHILE THERE IS SOME BASIS FOR OPTIMISM IN THESE REFORMS, FOREIGN INVESTMENT ALONE WILL NOT GET CROATIA'S ECONOMY FULLY ON TRACK. THE LONGER THE GOVERNMENT POSTPONES TOUGH CHOICES ON SPENDING, THE LONGER THE COUNTRY IS LIKELY TO BE SADDLED WITH HIGH UNEMPLOYMENT, DEFICITS AND DEBT.

FRANK